

In the Supreme Court of the United States

32

OCTOBER TERM, 1948.

Nos. 32 and 33.

33

COMMISSIONER OF INTERNAL REVENUE,  
*Petitioner,*

VS.

LEWIS F. JACOBSON,  
*Respondent.*

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT  
OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF ON BEHALF OF LEWIS F. JACOBSON.

WM. B. COCKLEY,  
THEODORE R. COLBORN,  
WALTER A. MARTING,

1759 Union Commerce Building,  
Cleveland 14, Ohio,

SIDNEY C. NIERMAN,  
33 North LaSalle Street,  
Chicago 2, Illinois,

*Attorneys for Lewis F. Jacobson,  
Respondent-Taxpayer.*

## INDEX.

Opinions Below .....	1
Jurisdiction .....	1
Questions Presented .....	2
Statement .....	2
Summary of Argument .....	3
Argument .....	5
I. Within the Framework of This Court's Decisions, the Cancellation of Indebtedness Here Was A Gift Excluded From Taxable Income .....	5
A. This Case Is Controlled by Helvering v. American Dental Company, 318 U. S. 322....	5
B. The Decision in The American Dental Co. Case Is Correct and Should Not Be Limited or Overruled .....	10
C. The Present Case Is Entirely Distinguishable from United States v. Kirby Lumber Co., 284 U. S. 1 .....	12
D. Congress Has Indicated No Intent that Gra- tuitous Cancellations of Indebtedness Be Taxed .....	16
II. Within the Meaning of the Sixteenth Amendment and the Internal Revenue Code, the Cancellation of Indebtedness Here Did Not Create Income Because There Was No Gain Derived From Labor or Capital .....	18
Conclusion .....	26

## TABLE OF AUTHORITIES.

### Cases Cited or Distinguished.

<i>Blair v. Rossiter</i> , 33 F. 2d 286 (C. C. A. 9, 1929) . . . . .	11
<i>Bogardus v. Commissioner</i> , 302 U. S. 34 . . . . .	12, 16, 22
<i>Bulkley Building Co. v. Commissioner</i> , T. C. (M) No. 109679, C. C. H. Dec. 14306M . . . . .	9, 15
<i>Campau, A. M., Realty Co. v. United States</i> , 69 F. Supp. 133 (Ct. Claims, 1947) . . . . .	15
<i>Carroll-McCreary Co. v. Commissioner</i> , 124 F. 2d 303 (C. C. A. 2d 1941) . . . . .	8, 14
<i>Chenango Textile Corp. v. Commissioner</i> , 148 F. 2d 296 (C. C. A. 2, 1945) . . . . .	8
<i>Claridge Apartments Co. v. Commissioner</i> , 323 U. S. 141 . . . . .	17, 18
<i>Commissioner v. Auto Strop Safety Razor Co.</i> , 74 F. 2d 226 (C. C. A. 2d 1934) . . . . .	14
<i>Commissioner v. Capento Securities Corp.</i> , 140 F. 2d 382 (C. C. A. 1st, 1944) . . . . .	13
<i>Commissioner v. Rail Joint Co.</i> , 61 F. 2d 751 (C. C. A. 2d 1932) . . . . .	13
<i>Commissioner v. Sherman</i> , 135 F. 2d 68 (C. C. A. 6th 1943) . . . . .	13
<i>Commissioner v. Smith</i> , 324 U. S. 177 . . . . .	22, 23
<i>Continental Tie &amp; Lumber Co. v. United States</i> , 286 U. S. 290 . . . . .	22
<i>Corporacion de Ventas de Salitre y Yoda de Chile v. Commissioner</i> , 130 F. 2d 141 (C. C. A. 2d 1942) . . . . .	13
<i>Crow v. Gore et al.</i> , 85 F. 2d 291 (App. D. C. 1936) . . . . .	7
<i>Edwards v. Cuba Railroad Co.</i> , 268 U. S. 628 . . . . .	21
<i>Eisner v. Macomber</i> , 252 U. S. 189 . . . . .	21
<i>Fire Insurance Association, Limited v. Wickham</i> , 141 U. S. 564 . . . . .	9

<i>Helvering v. American Chicle Co.</i> , 291 U. S. 426 . . . . .	18, 25
<i>Helvering v. American Dental Co.</i> , 318 U. S. 322 . . . . .	3, 4, 5, 6, 7, 8, 10, 11, 12, 14, 15, 16, 18, 19, 25
<i>Helvering v. A. L. Killian Co.</i> , 128 F. 2d 433 (C. C. A. 8th 1942) . . . . .	13
<i>Hirsch v. Commissioner</i> , 115 F. 2d 656 (C. C. A. 7th 1940) . . . . .	13
<i>McConway &amp; Torley Corp. v. Commissioner</i> , 2 T. C. 593 (1943) . . . . .	8
<i>Noel v. Parrott</i> , 15 F. 2d 669 (C. C. A. 4, 1926) . . . . .	11
<i>Old Colony Trust Co. v. Commissioner</i> , 279 U. S. 716 . . . . .	12, 16
<i>Palmer v. Commissioner</i> , 302 U. S. 63 . . . . .	22
<i>Shellabarger Grain Products Co. v. Commissioner</i> , 146 F. (2d) 177 (C. C. A. 7th, 1944) . . . . .	8, 15
<i>Stratton's Independence, Ltd. v. Howbert</i> , 231 U. S. 399 . . . . .	21
<i>Tanner Mfg. Co. v. Commissioner</i> , Doc. 110068, 2 T. C. (M) 305, CCH Dec. 11319 (M) . . . . .	8
<i>Terminal Investment Co. v. Commissioner</i> , 2 T. C. 1004 (1943) . . . . .	13
<i>Texas &amp; Pacific Railway Co. v. United States</i> , 286 U. S. 285 . . . . .	21-22
<i>United States v. Kirby Lumber Co.</i> , 284 U. S. 1 . . . . .	4, 12, 13, 14, 16, 17, 18, 19, 25

### Texts.

<i>Magill, Taxable Income</i> , p. 255 . . . . .	25
<i>Merten's Law of Federal Income Taxation</i> , Vol. 1, Sec. 6.07, pages 241 <i>et seq.</i> . . . . .	11
<i>Tarbleau, "Federal Income Tax Considerations Applicable to Cancellation of Indebtedness;" Institute on Federal Taxation</i> (Fifth Annual—New York University—1947), p. 664 . . . . .	14
<i>Williston on Contracts</i> , Rev. Ed., Section 121 . . . . .	8

## Constitution, Statutes and Regulations.

Constitution of the United States, Sixteenth Amendment, .....	21
Bankruptcy Act (as amended by the Chandler Act), Sections 268, 270 and 276c(3) .....	18
Corporation Tax Act of 1909 .....	21
Internal Revenue Code and Revenue Act of 1938:	
Section 22(a) .....	2, 5, 18, 21
Section 22(b) .....	2, 18
Section 22(b)(3) .....	2, 3, 5, 12, 14, 16
Regulations 111, Section 29.22(a)-1 .....	21
Regulations 111, Sec. 29.22(c)-5 .....	20
Transportation Act of 1920 .....	21
28 U. S. C. 1254 .....	1

# In the Supreme Court of the United States

---

OCTOBER TERM, 1948.

**Nos. 32 and 33.**

---

COMMISSIONER OF INTERNAL REVENUE,  
*Petitioner,*

vs.

LEWIS F. JACOBSON,  
*Respondent.*

---

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT  
OF APPEALS FOR THE SEVENTH CIRCUIT.

---

**BRIEF ON BEHALF OF LEWIS F. JACOBSON.**

---

## **OPINIONS BELOW.**

The opinion of the Court of Appeals for the Seventh Circuit (R. 166-174) is officially reported in 164 F. 2d 594. The opinion of the Tax Court of the United States (R. 120-135) is reported in 6 T. C. 1048.

## **JURISDICTION.**

The judgment of the Court of Appeals for the Seventh Circuit was entered on December 5, 1947 (R. 174-175). The petition for writs of certiorari was filed on March 5, 1948 and granted on April 5, 1948 (R. 177). The jurisdiction of this Court is conferred by Title 28, United States Code, Section 1254.

## QUESTIONS PRESENTED.

The ultimate question presented in this case is whether the court below properly held that the taxpayer did not realize taxable income within the meaning of Section 22(a) and (b) of the Revenue Act of 1938 and the Internal Revenue Code because of his purchase at a discount of his own mortgage bonds, as a result of transactions carried out between the taxpayer and the bondholders.

This ultimate question can be broken down into two subsidiary issues, which are:

1. Within the framework of the existing decisions of this Court, is any gain resulting from the taxpayer's purchase of his bonds at a discount excluded from taxable income as a gift under Section 22(b)(3) of the Revenue Act of 1938 and the Internal Revenue Code?

2. In view of the basic conceptions of income, is the cancellation of indebtedness here "income" within the meaning of Section 22(a) of the Revenue Act of 1938 and the Internal Revenue Code?

## STATEMENT.

Petitioner's statement of facts contains an accurate summary of most of the pertinent facts found by the Tax Court. We point out, however, that the references to purchases of bonds by the taxpayer through "brokers" or through "the Bondholders' Committee" (Petitioner's Brief pp. 5 and 6) in no sense means open market purchases. In each instance the broker or Secretary of the Bondholders' Committee was acting either as agent of one party or the other, both the bondholder and the taxpayer having full knowledge of such agency. For the purpose of its opinion the Court of Appeals, after reviewing the undisputed evidence as to these purchases in detail, considered them to be purchases made through agents with full knowledge on both sides of the agency. The Court of Appeals

accepted the Tax Court's finding that the taxpayer was solvent during each of the years in question, but noted that "a perusal of the record makes it quite apparent that he was in straitened financial circumstances." (R. 166-172.)

## SUMMARY OF ARGUMENT.

### I.

In *Helvering v. American Dental Co.*, 318 U. S. 322, this Court held that where creditors forgave the unpaid portion of the taxpayer's indebtedness upon its partial payment, the resulting gain in the taxpayer's net assets, received gratuitously, was a gift excluded from taxable income by Section 22(b)(3) of the Revenue Acts and the Internal Revenue Code. In the present case the taxpayer received a partial forgiveness of his indebtedness by purchasing certain of his outstanding bonds at less than their face amount in direct transactions with his creditors. Such gratuitous cancellation of his indebtedness was a gift excluded from his taxable income under the *American Dental Co.* case.

The only distinction the Petitioner claims between the *American Dental Co.* case and this is that here the creditors received technical legal consideration in that the bonds had not yet matured. This distinction is of no significance. The principle of contract law, that prepayment is sufficient consideration for an executory contract, is a highly technical one to avoid hardships and is inapplicable in practical matters of taxation. The lower courts have uniformly recognized that such technical legal consideration is immaterial under the *American Dental Co.* case. Even in a contract sense, such prepayment is consideration only where intended by the parties as such, which was not the case here.

The arguments presented by the Petitioner that the opinion in the *American Dental Co.* case, and its holding, should in effect be overruled, are simply those previously

presented to this Court and properly rejected in that case. The facts of *United States v. Kirby Lumber Co.*, 284 U. S. 1, where this Court held that the taxpayer's purchase of its bonds on the open market resulted in taxable income, are distinguishable, as this Court recognized in the *American Dental Co.* case. In an open market transaction the creditors could not have intended to forgive the indebtedness and hence there was no gift. Congressional enactments since the *Kirby Lumber Co.* and *American Dental Co.* cases do not indicate any Congressional understanding or intent that cancellations of indebtedness generally should be considered income, but rather approve this Court's previous holdings.

## II.

If this Court desires to re-examine the *American Dental Co.* case, as the Petitioner requests, it should also re-examine its holding in the *Kirby Lumber Co.* case. An application of the basic conceptions of income, in the light of this Court's decisions in related situations, makes it clear that a forgiveness of indebtedness arrived at in a self-contained arm's length transaction, such as is here involved, does not result in income. The language of the Sixteenth Amendment, the Revenue Acts and the Treasury Regulations all recognize that income is gain derived from capital or from labor or from both combined. Any gain resulting to this taxpayer from the partial forgiveness of his indebtedness in an arm's length transaction was not derived from capital or labor and hence cannot be considered income.

Not all gains are taxable income. A cancellation of indebtedness, like a gain from a bargain purchase, may be a gift, if occasioned by a desire to benefit the taxpayer. It may be income, if derived from the taxpayer's services or resulting from his ownership of stock. But if it is not derived from taxpayer's labor or capital, it is not income.

## ARGUMENT.

### I.

**WITHIN THE FRAMEWORK OF THIS COURT'S DECISIONS, THE CANCELLATION OF INDEBTEDNESS HERE WAS A GIFT EXCLUDED FROM TAXABLE INCOME.**

**A. This Case Is Controlled by *Helvering v. American Dental Company*, 318 U. S. 322.**

In the *American Dental Co.* case this Court held, after most careful consideration, that where creditors gratuitously forgave back interest and rent the amount forgiven was not to be included in taxable gross income under Section 22(a) of the Internal Revenue Code because it was an exempt gift under Section 22(b)(3) of that Code, stating in part at 318 U. S. 327-31:

"Normally cancellations of indebtedness occur only when the beneficiary is insolvent or at least in financial straits. Possibly because it seems beyond the legislative purpose to exact income taxes for savings on debts, the courts have been astute to avoid taxing every balance sheet improvement brought about through a debt reduction. \* \* \* (327)

\* \* \*

"In the light of these views upon gain, profit and income, we must construe the meaning of the statutory exemption of gifts from gross income by § 22(b)(3). The broad import of gross income in § 22(a) admonishes us to be chary of extending any words of exemption beyond their plain meaning. Cf. *Heiner v. Colonial Trust Co.*, 275 U. S. 232, 235; *United States v. Stewart*, 311 U. S. 60, 63. 'Gifts,' however, is a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear. Its plain meaning in its present setting denotes, it seems to us, the receipt of financial advantages gratuitously.

"The release of interest or the complete satisfaction of an indebtedness by partial payment by the volun-

tary act of the creditor is more akin to a reduction of sale price than to financial betterment through the purchase by a debtor of its bonds in an arm's length transaction. \* \* \* (329-30)

\* \* \* Section 22(b)(3) exempts gifts. This does not leave the Tax Court of the United States free to determine at will or upon evidence and without judicial review the tests to be applied to facts to determine whether the result is or is not a gift. The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute." (330-31)

The only significant difference claimed by the Petitioner between the facts of the *American Dental Co.* case and the present case is that here the bonds were purchased before maturity at a discount and the cancellation of the remaining debt by the creditors was therefore supported by technical legal consideration. In the *American Dental Co.* case this was not true. There some creditors forgave past due interest without any technical legal consideration other than the continued good will of a customer and a landlord agreed to accept payment of \$7,500 in lieu of a much larger amount for past due rent.

In both the *American Dental Co.* case and the present case the taxpayers, although not insolvent, were in straitened financial circumstances. After negotiating and dealing directly with their respective creditors the taxpayers in both cases obtained a cancellation of a portion of their obligations by making a partial payment. In both cases the taxpayers and their creditors dealt at arm's length and attempted to achieve the best financial outcome from their own selfish points of view. In both the creditors knew that they were settling their claims against the debtor for a smaller amount than actually owed and intended the debtor to obtain the benefit of the cancellation. In both,

the only valuable consideration that passed between the parties was the partial payment.

In the *American Dental Co.* case there was a prepayment in the business sense. Except by such a settlement the landlord, in order to receive payment of his claim, would have had to await the uncertain outcome of legal proceedings. If prepayment is presumed to be an important consideration in this case, it was so in the same sense in the *American Dental Co.* case.

The slight difference in fact, namely the existence in the present case of a technical legal consideration and its absence in the *American Dental Co.* case, is not a sound basis for distinction and for these reasons:

*First:* This rule of contract law regarding prepayment of a debt was developed by the courts to alleivate the harshness of the common law rule that the payment of a smaller sum than that due is not sufficient consideration to support a promise to forgive the balance and has always been recognized as highly technical.<sup>1</sup> Taxation is a practical matter and the courts will always look through form to substance in resolving tax questions. When this Court

<sup>1</sup> In *Crow v. Gore et al.*, 85 F. 2d 291 (App. D. C. 1936), one of the cases cited by the Petitioner (Pet. Brief 19), the court stated at pp. 293-294:

"\* \* \* It is said in 6 R. C. L. 665: 'At an early date the rule that the performance of a legal obligation does not furnish a consideration for a contract was applied to a promise to discharge a liquidated debt upon the payment of a smaller sum on the date fixed by the contract or after default.' \* \* \*

As the rule is not favored the decisions indicate in a striking manner the extreme ingenuity of the courts in avoiding its operation. They have failed to apply the rule whenever they could discover some circumstance, however trifling, which would be considered as a technical legal consideration. Accordingly, if the creditor accepts a part payment in a manner different from that required by the contract or before the maturity of the debt, a sufficient new and additional consideration for his promise to discharge the entire debt is deemed to be present." (Emphasis here and elsewhere supplied.)

referred to the gratuitous cancellation of indebtedness or the release by the creditor to the debtor of something for nothing, it intended that the criterion or standard to be applied is not whether there was any technical consideration to support the forgiveness but whether the creditor received anything of real value over and above the part payment. To read into the language of the *American Dental Co.* case the qualification that any technical consideration for the cancellation makes it non-gratuitous and taxable would completely emasculate the effect of that decision.<sup>2</sup>

*Second:* All lower courts, in interpreting the rule of the *American Dental Co.* case, have recognized that whether a particular cancellation is gratuitous depends not on whether there was any technical consideration to support the cancellation but whether the creditor received anything of real value for it. In many cases decided since the *American Dental Co.* case there has been sufficient consideration within the meaning of contract law to support the promise of the creditor to forgive a portion of the debt. However, in all of these cases the courts held the cancellation gratuitous in spite of the presence of technical legal consideration.<sup>3</sup> Whether prepayment is sufficient consideration to make a cancellation of an indebtedness non-gratuitous has been litigated in two lower court cases. These are *Shellabarger Grain Products Co. v. Commissioner*, 146 F. (2d) 177 (C. C. A. 7th, 1944), which involved a taxpayer satisfying a note for \$28,030.30 by a cash payment of \$20,000.00 in advance of the due date, and *Bulkley*

<sup>2</sup> It would then be held that the *American Dental Co.* decision would not apply if a partial payment was made in a medium of payment different from that provided or at a different place or to someone other than the creditor. See *Williston on Contracts*, Rev. Ed. Section 121.

<sup>3</sup> *McConway & Torley Corp. v. Commissioner*, 2 T. C. 593 (1943); *Tanner Mfg. Co. v. Commissioner*, Doc. 110068, 2 T. C. (M) 305, CCH Dec. 11319 (M); *Chenango Textile Corp. v. Commissioner*, 148 F. 2d 296 (C. C. A. 2, 1945); and *Carroll-McCreary Co. v. Commissioner*, 124 F. 2d 303 (C. C. A. 2d 1941).

*Building Co. v. Commissioner*, T. C. (M) No. 109679, C. C. H. Dec. 14306M, in which the debentures which were purchased at a discount in the year 1938 did not mature until 1943. Both courts held that the cancellation of indebtedness was exempt as a gift in spite of the fact that the indebtedness was prepaid.

*Third*: Even in the field of contract law this prepayment rule applies only where both the debtor and creditor agree and intend that the prepayment is the consideration for the cancellation. This Court, in *Fire Insurance Association, Limited v. Wickham*, 141 U. S. 564, stated at page 579:

“ \* \* \* That prepayment of part of a claim may be a good consideration for the release of the residue is not disputed; but it is subject to the qualification that nothing can be treated as a consideration that is not intended as such by the parties. \* \* \* In *Kilpatrick v. Muirhead*, 16 Penn. St. 117, 126, it was said that ‘consideration, like every other part of a contract, must be the result of agreement. The parties must understand and be influenced to the particular action by something of value or convenience and inconvenience recognized by all of them as the moving cause. That which is a mere fortuitous result flowing accidentally from an arrangement, but in no degree prompting the actors to it, is not to be esteemed a legal consideration.’ See also 1 *Addison on Contracts*, 15; *Ellis v. Clark*, 110 Mass. 389. Now evidence of what took place at the meeting, if admissible for no other purpose, was competent as bearing upon the question ‘whether the prepayment was mentioned or treated as an inducement or consideration for the release of the residue of the claim.’”

There is no evidence in the present case that the taxpayer or the bondholders considered this question of prepayment in their negotiations. On the contrary, the evidence is uncontradicted that there was no consideration received by the bondholders other than the amount paid (R. 35). It should be emphasized that neither the Tax Court nor the Court of Appeals made any finding or int-

mated that prepayment was even considered, discussed or mentioned by either the taxpayer or his creditors in the negotiation, sale or settlement. It must be recalled that the creditors in 1937 extended the maturity date of the bonds until 1942. It is unrealistic to assume that a creditor will extend his bond in one year and within the next year accept 50¢ on the dollar for it if prepayment was the inducing cause of the sale.

Therefore, it cannot be argued that the real inducement or consideration for the cancellation was the prepayment. It was merely a fortuitous result brought about by the sale of the bonds prior to their maturity rather than the reason prompting the taxpayer and the bondholders to consummate the sale.

For the above reasons both the Court of Appeals and the Tax Court were correct in holding that the present case was controlled by the *American Dental Co.* case and that the prepayment did not distinguish the present case nor make the cancellation non-gratuitous.

**B. The Decision in The American Dental Co. Case Is Correct and Should Not Be Limited or Overruled.**

Petitioner throughout his Brief raises the same arguments made by the Commissioner in the *American Dental Co.* case and attempts to have this Court overrule its former decision that a gratuitous cancellation of indebtedness is exempt from income tax as a gift. He again ignores the common and accepted definition of the term "gift" as approved in the *American Dental Co.* case and attempts to qualify it by the use of such vague and general terms as "arm's length negotiations," "business transactions," and "donative intent."

A gift, as defined by the authorities, is a voluntary transfer of property by one to another without any consideration or compensation therefor, or, as this Court said in the *American Dental Co.* case, the receipt of financial

advantages gratuitously. See *Mertin's Law of Federal Income Taxation*, Vol. 1, Sec. 607, pages 241 *et seq.*; *Blair v. Rossiter*, 33 F. 2d 286 (C. C. A. 9, 1929); *Noel v. Parrott*, 15 F. 2d 669, 671 (C. C. A. 4, 1926).

The fact that the cancellation of indebtedness in the present case arose out of a so-called business transaction and that both taxpayer and the bondholders attempted to strike the best possible bargain has nothing to do with whether the cancellation was a gift. The test is whether any valuable consideration was given by the taxpayer for the cancellation. In the *American Dental Co.* case the cancellation was accomplished by means of a business transaction and presumably both the debtor and his creditors tried to strike the best bargain. This did not make the cancellation non-gratuitous and therefore not a gift.

Petitioner argues that the cancellation was not a gift because there was "no donative intent" on the part of the creditors. There is no question but that in the present case the creditors intended to cancel a portion of their claims against the taxpayer and intended that he should receive the benefit of this cancellation without paying anything for it. In the *American Dental Co.* case the evidence shows that the creditors there likewise intended that the debtor should receive the benefit of the cancellation.

Petitioner is confusing the terms "intent" and "motive," and is really saying that if the motive for the cancellation is a business one, the cancellation cannot be gratuitous. As this Court held in the *American Dental Co.* case, the motives are not controlling. The common, accepted definition of the term "gift" shows that the motives of the donor have no bearing on whether a particular transfer is a gift. The significant fact is that in the present case the creditors intended to cancel a portion of their debt without receiving any valuable consideration. What their motives were is of no importance.

This is just what this Court held in *Bogardus v. Commissioner*, 302 U. S. 34 and *Old Colony Trust Co. v. Commissioner*, 279 U. S. 716, with respect to the question whether a bonus to a former employee was a gift or taxable income. The touchstone was held to be the intent of the parties—whether to compensate for services or to make a gift. Their motive—gratitude for past services—was found to be of no significance.

All of these same arguments were presented to this Court in the *American Dental Co.* case. This Court, however, resolved all these issues by holding that when a creditor cancels all or a portion of his claim against his debtor for no consideration, this cancellation is gratuitous and the amount of the forgiven debts is exempt from income tax as a gift within the meaning of Section 22(b)(3) of the Internal Revenue Code.

**C. The Present Case Is Entirely Distinguishable from *United States v. Kirby Lumber Co.*, 284 U. S. 1.**

The Petitioner argues that the present case is governed by the rule of the *Kirby Lumber Co.* case. Here also the Petitioner is simply again arguing points presented to this Court in the *American Dental Co.* case and completely rejected by it then.

The *Kirby Lumber Co.* case was the first decision determining whether any taxable income resulted from a purchase by a debtor of his own obligations at less than their issue price. Its facts were quite simple. Kirby Lumber Co. had issued bonds in 1923 for a little over \$12,000,000 and received in cash the par value thereof. Later in the same year it purchased in the open market some of the bonds at a substantial discount and presumably cancelled them. There being no evidence of any shrinkage in assets, this Court, speaking through Mr. Justice Holmes, held that there was a gain in assets previously offset by the obligation of bonds now extinct. Be-

cause of this gain the Court held that it had realized taxable income to that extent.

After the decision in the *Kirby Lumber Co.* case it was quickly realized by the courts and the Treasury Department that every improvement in net assets on the balance sheet of a taxpayer (brought about by a cancellation of his indebtedness) did not result in taxable income. The broad ground upon which the case was placed by Mr. Justice Holmes has been greatly limited and curtailed by the later holdings, although the case has never been directly overruled. The lower courts refused to apply it in many situations even where it clearly appeared that the cancellation did increase the debtor's net assets.

Where the indebtedness was incurred as a part of the purchase price of property, the courts have consistently held that a cancellation of a part of such indebtedness should be treated as a readjustment of the purchase price rather than a taxable gain. See *Hirsch v. Commissioner*, 115 F. 2d 656 (C. C. A. 7th 1940); *Helvering v. A. L. Kilian Co.*, 128 F. 2d 433 (C. C. A. 8th 1942); *Commissioner v. Sherman*, 135 F. 2d 68 (C. C. A. 6th 1943).

If the debt is retired by the issuance of stock worth considerably less than the debt, it does not result in taxable income. See *Commissioner v. Capento Securities Corp.*, 140 F. 2d 382 (C. C. A. 1st, 1944).

If the indebtedness is incurred without consideration, its subsequent cancellation does not represent taxable income. See *Commissioner v. Rail Joint Co.*, 61 F. 2d 751 (C. C. A. 2d 1932).

If the cancelled debt is contingent and not absolute, no taxable income results from its cancellation. See *Corporation de Ventas de Salitre y Yoda de Chile v. Commissioner*, 130 F. 2d 141 (C. C. A. 2d 1942); *Terminal Investment Co. v. Commissioner*, 2 T. C. 1004 (1943).

The Treasury Department in its regulation and the lower courts have held that where a stockholder gratuitous-

ly forgives the corporation's debt, it results in a contribution to the capital of the corporation and not a taxable gain. See *Commissioner v. Auto Strop Safety Razor Co.*, 74 F. 2d 226 (C. C. A. 2d 1934); *Carroll-McCreary Co., Inc. v. Commissioner*, *supra*.

Finally, this Court in the *American Dental Co.* case held that where a creditor gratuitously forgave indebtedness in whole or in part, such forgiveness was wholly exempt under Section 22(b)(3) of the Internal Revenue Code, although there was unquestionably an increase in the taxpayer's net assets.

Thomas M. Tarleau in an article on *Federal Income Tax Considerations Applicable to Cancellation of Indebtedness* published in *Institute on Federal Taxation* (Fifth Annual—New York University—1947), p. 664 correctly summed up the present status of the *Kirby Lumber Co.* case by stating at page 666:

"The doctrine of *United States v. Kirby Lumber Co.* is still followed in decisions dealing with cancellation of indebtedness, but various exceptions which have been developed have tended to limit such doctrine in practical effect to cases involving the repurchase by a corporation of its bonds at a discount on the open market."

As the Court of Appeals held below, the *Kirby Lumber Co.* case is entirely distinguishable from the present case. In the *Kirby Lumber Co.* case there was not and could not have been any discussion of the question of gratuitous cancellation of indebtedness. There were no negotiations between the Kirby Lumber Co. and its bondholders. Both treated the bonds merely as property to be sold or purchased on the open market. The bondholders could not have had any idea that they were selling to the corporation and thus in effect forgiving a part of their claim. The bondholders did not and could not have intended to cancel any claim against the debtor. As far as they knew such claim remained outstanding in the hands of a new owner.

There was no intent whatever to forgive any indebtedness or otherwise benefit the debtor.

In the present case, on the other hand, each bondholder dealt directly with the taxpayer or his agent. The bondholder, in selling his bond at a discount to the taxpayer, knew that he was surrendering and forgiving the unpaid portion of the debt. He intended to do this and he intended that the debtor should have the advantage of his doing this. Thus, each creditor knowingly and intentionally gave the benefit of the forgiveness to the taxpayer—a true gift, as this Court has held.

It is true that from the economic standpoint of the taxpayer, it makes no difference whether he acquires his obligations in an open market transaction or in a direct transaction with his creditor. In both cases his net assets are increased by the difference between the amount paid and the amount of the debt retired. As previously pointed out, however, this gain in net assets is not the sole test. The distinction between the two types of cases is that normally in an open market transaction there can be no intended cancellation of indebtedness on the part of the creditor since he has no knowledge that his debtor is obtaining a reduction or cancellation of the amount due. He therefore cannot be considered to have made a gift. This is the reasoning of the Tax Court and the Court of Appeals in this case. All cases decided since the *American Dental Co.* case on similar facts have held the same way. See *Bulkley Building Co. v. Commissioner*, *supra*; *Shellabarger Grain Products Co. v. Commissioner*, *supra*; *A. M. Campau Realty Co. v. United States*, 69 F. Supp. 133 (Ct. Claims, 1947).

The same is true in the employee bonus cases. From the employee's standpoint the result to him is the same whether the bonus is a gift or is compensation for services. However, whether the bonus is taxable to him depends on whether the employer intended to make him a gift or intended to compensate him for past or future services. *Old*

*Colony Trust Company v. Commissioner*, 279 U. S. 716;  
*Bogardus v. Commissioner*, 302 U. S. 34.

For the above reasons the Court of Appeals and the Tax Court correctly held the doctrine of the *Kirby Lumber Co.* case inapplicable to the present case, just as this Court held on the same question in the *American Dental Co.* case.

**D. Congress Has Indicated No Intent that Gratuitous Cancellations of Indebtedness Be Taxed.**

Petitioner argues that since Congress has specifically excluded certain cancellations of indebtedness from taxable gross income (see statutes cited by Pet. Brief, 32-35), all other cases of cancellation of indebtedness should be subject to the income tax. However, as the *American Dental Co.* case held, Congress had already exempted gratuitous cancellations of indebtedness in Section 22(b)(3) of the Internal Revenue Code. If the *American Dental Co.* decision did not represent the intent of Congress in enacting Section 22(b)(3), Congress has had ample time since to point out this Court's error. By failing to make such amendment, Congress has shown its approval of the holding of the *American Dental Co.* case that gratuitous cancellations of indebtedness are gifts excluded from gross income under Section 22(b)(3).

All of the specific statutory exceptions referred to by Petitioner were considered in the *American Dental Co.* case and were cited to illustrate "the uncertainties of the effect of the remission of indebtedness on income tax." (318 U. S. 328.) The enactment by Congress of these specific exemption sections does not in fact indicate any conviction on its part that cancellation or reduction of indebtedness does necessarily result in taxable income even in the circumstances there involved. These sections were motivated by a desire to clarify what was regarded by all as uncertainty in the law rather than to change the existing

rules regarding the taxability of debt cancellations. This circumstance, and the unfortunate confusion resulting from it, is clearly pointed out by this Court in its opinion in *Claridge Apartments Co. v. Commissioner*, 323 U. S. 141. Discussing the uncertainty with respect to the income-producing effect of cancellations of indebtedness, this Court said (p. 146):

"Some of the obscurity has been created by the very legislation enacted to remove it. This has been true of the successive 'reorganization' provisions, including those for 'non-recognition' and for transfer of 'basis,' which have appeared in the various revenue acts from 1918 (cf. 40 Stat. 1057) forward. Closely related, as these have been, to the problem whether income is realized by the cancellation or reduction of indebtedness in connection with a reorganization, they have tended to obscure if not to blot out that problem altogether in situations covered by their terms."<sup>11</sup>

<sup>11</sup> By assuming the existence of income or other taxable gain, but providing for nonrecognition, the inquiry whether gain or profit actually has accrued is wholly avoided."

Of course, these special statutory provisions do have an important effect where, under other circumstances, reduction or cancellation of indebtedness may result in taxable income. In a situation, for example, where under the *Kirby Lumber Co.* case a purchase and retirement of bonds would be held to result in taxable income, the taxpayer has the option under these sections of postponing the tax to a later time through reduction of the cost basis of his properties.

**WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT AND THE INTERNAL REVENUE CODE, THE CANCELLATION OF INDEBTEDNESS HERE DID NOT CREATE INCOME BECAUSE THERE WAS NO GAIN DERIVED FROM LABOR OR CAPITAL.**

The Petitioner has asked this Court to reexamine its opinion in the *American Dental Co.* case. He urges this Court to restate the governing principles within the scope of the Sixteenth Amendment and the Internal Revenue Code applicable in determining whether a particular cancellation of indebtedness results in taxable income.

We have set forth in the first section of this brief the reasons why we believe that this Court can and should hold, within the framework of its existing decisions, that the gratuitous cancellation of Respondent's indebtedness, made at arm's length in personal transactions with his creditors, did not result in income taxable to him within the meaning of Section 22(a) and (b) of the Internal Revenue Code. We suggest, however, that if this Court desires to reexamine the fundamental law applicable in these situations, it must reexamine not only the *American Dental Co.* case but its earlier decisions in the *Kirby Lumber Co.* and *American Chicle Co.* cases; in light of its more recent pronouncements in related fields and the basic conceptions of what is income. We are convinced that any such reexamination can only result in the conclusion that the transactions between the taxpayer here and his creditors did not result in any taxable income under Section 22(a).

The most recent reference by this Court to the confusing problem of the income tax treatment of debt cancellation is in its opinion in *Claridge Apartments Co. v. Commissioner*, 323 U. S. 141. We say "confusing" advisedly. That case involved the interpretation of Sections 268, 270 and 276e(3) of the Bankruptcy Act, as amended by the Chandler Act, which related to the income tax treatment of cancellation of indebtedness resulting

from bankruptcy proceedings. This Court introduced its detailed discussion of these sections and their legislative history and effect by reference to the *Kirby Lumber Co.* and *American Dental Co.* cases, saying (p. 146):

"The question presented by Sec. 276c (3) must be determined in the light of the problem created by §§ 268 and 270. A statement of their history is necessary to a general understanding of that problem. It stems basically from *United States v. Kirby Lumber Co.*, 284 U. S. 1, and subsequent decisions which have applied the principle of that case.<sup>9</sup> By them a corporation may realize income from the cancellation or reduction of indebtedness, depending upon the circumstances in which the transaction occurs. However, the line between income-producing reductions and others is not precise or definite and great uncertainty prevailed concerning it, \* \* \*"

<sup>9</sup> Cf., e.g., *Helvering v. American Dental Co.*, 318 U. S. 322; *Kraman Dev. Co.*, 3 T. C. 342; *Paul, Debt and Basis Reduction under the Chandler Act* (1940) 15 Tulane L. Rev. 1, 5, and authorities cited in notes 17, 19."

In the seventeen years since this Court's decision in the *Kirby Lumber Co.* case, tax practitioners and commentators have uniformly<sup>2</sup> recognized, and generally bewailed, the uncertainty of the income tax effect of cancellations or reductions of indebtedness.<sup>4</sup> The lower courts have been astute in refinements and distinctions, limiting what was thought to be the rationale of the holding in the *Kirby Lumber Co.* case—that an increase in a debtor's net assets through purchase of his obligations at a discount constitutes an "accession to income" (284 U. S., at 3), includable in taxable income. *Supra*, pp. 13-14.

This confusion was of concern to this Court when it decided the *American Dental Co.* case. After referring to its previous holding that the purchase of a taxpayer's own

<sup>4</sup> See articles cited Petitioner's Brief, p. 13, footnote 2 and article cited *supra*, p. 14.

bonds at a discount resulted in income, and to the "narrow line" in related situations, this Court recognized that:

"Possibly, because it seems beyond the legislative purposes to exact income taxes for savings on debts, the courts have been astute to avoid taxing every balance sheet improvement brought about through a debt reduction." (318 U. S., at 327.)

Much of this confusion, we respectfully submit, has resulted from a failure to recognize the essential limits on the broad scope of the concept of "income." It might conceivably have been held that increases in the net worth of a taxpayer measured his taxable income, but from the first decisions on the scope of income tax statutes, that all-inclusive concept was rejected. Mere appreciation in the value of a taxpayer's property, although it increases both the value of his assets and his net worth, is not income. That the taxpayer's securities or business property are more valuable at the end of the taxable year than at its commencement is ignored. A taxpayer engaged in business may be wealthier at the conclusion of the period because the selling price of his inventory or stock in trade has increased, but that does not result in income.<sup>5</sup> A farmer does not realize income because a valuable crop grows on his land or because his prize cow has a calf. A desert landholder would not have income when a stream reversed its course and made his desert productive. Nor would the recession of a lake relieving the shore land from the burden of its waters bring income to the owner.

All of these are gains—gains in gross assets and in net assets, but gains alone are not enough. To constitute income, gains must be "derived from capital, from labor, or from both combined." This was the definition of income

<sup>5</sup> However, in exceptional circumstances a dealer in securities is permitted to value inventories at market value, thereby increasing or reducing his income with market fluctuations. Regulations 111, Sec. 29.22(c)-5,—an exception to the general rule by agreement between the taxpayer and the Commissioner on account of the special nature of that business.

under the Corporation Tax Act of 1909 declared by this Court in *Stratton's Independence, Ltd. v. Howbert*, 231 U. S. 399. In the Sixteenth Amendment Congress was empowered "to lay and collect taxes on incomes, from whatever source *derived*, without apportionment \* \* \*," thereby incorporating the same accepted meaning of the term. See *Eisner v. Macomber*, 252 U. S. 189.

Congress itself clearly recognized the qualification that income includes only gains derived from capital or labor. In Section 22(a) of the Revenue Acts and the Internal Revenue Code it defines "gross income" to include "gains \* \* \* derived from \* \* \* compensation for personal service \* \* \* or from \* \* \* businesses \* \* \* or dealings in property \* \* \*; and income derived from any source whatever." Not all gains are taxed. As the Treasury Department Regulations themselves provide, "income is the gain derived from capital, from labor, or from both combined \* \* \*" (Regulations 111, Section 29.22(a)-1, and prior regulations).

The gain, to be income, must thus be derived from an income-producing transaction or circumstance. Whether a particular gain or profit is income has been decided by an analysis of the circumstances of the gain, and the intent of the parties toward it.

When early confronted with the question whether a Government subsidy to a new railroad was income; this Court analyzed the circumstances of the payment, found that it was not made for services rendered, and that it was not gain "from the use or operation of the railroad," and accordingly held that the payment under those circumstances did not constitute income. *Edwards v. Cuba Railroad Co.*, 268 U. S. 628. On the other hand, when Congress in the Transportation Act of 1920 authorized payments to railroads to restore their income for the period of federal control to a normal operating level, the Court held that such payments were derived by the railroads from their operations and hence constituted income. *Texas & Pacific Rail*

*Way Co. v. United States*, 286 U. S. 285 and *Continental Tie & Lumber Co. v. United States*, 286 U. S. 290.

After long uncertainty as to the taxable status of so-called bonuses paid to former employees, this Court held in *Bogardus v. Commissioner*, 302 U. S. 34, that where "the disbursements were not made or intended to be made for any services rendered or to be rendered or for any consideration," they were not income. Whether the payment was "derived from" services was held to depend on the intent with which it was made.

Most revealing of all, it is now firmly established that where a taxpayer makes a bargain purchase—secures a gain in his net assets by buying something for less than it is actually worth—such gain is income if it is derived from labor or capital, but is not income if the bargain sale was intended as a separate and distinct transaction unrelated to other circumstances. *Palmer v. Commissioner*, 302 U. S. 63; *Commissioner v. Smith*, 324 U. S. 177.

In the *Palmer* case, United Corporation sold to its stockholders stock it owned in the newly organized American Superpower Co. The price of \$25 per share was fixed by the directors as their evaluation of the market value of the stock, but during the three weeks period required for completing the sale it became apparent that the stock was worth far more. This Court held that since there was no intent to distribute any gain to the stockholders, but a bona fide intent to make a straightforward sale of the stock, there was no income. "One does not subject himself to income tax by the mere purchase of property, even if at less than its true value." (302 U. S., at 69.) Such a sale may, of course, be the distribution of a dividend, if intended as such. "But the bare fact that a transaction, on its face a sale, has resulted in a distribution of some of the corporate assets to stockholders, gives rise to no inference that the distribution is a dividend." (302 U. S., at 69-70.)

So with bargain sales made as compensation to employees. In *Commissioner v. Smith*, 324 U. S. 177, an em-

ployer, in consideration of an employee's services, had given him the right to buy at 10¢ per share stock found to have a much higher value when the employee purchased it. This Court declared that "Section 22(a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee *as compensation*." (324 U. S., *post* 181.) Since the intent was not simply to make a self-contained sale, but rather to confer on the employee something of value derived from his services, this Court held the gain income. As has been frequently held, where there is no intent to compensate, such a bargain purchase is not income.

Thus if a taxpayer achieves a gain by increasing his assets through a bargain purchase, there may be no effect on his income—if the bargain purchase was a self-contained transaction. Such gain may indeed be income, if derived from the taxpayer's services, his ownership of securities or from dealings in property. It may, too, be a gift if the gain was intended to be transferred to the recipient gratuitously and with the intent of benefiting him.

If cancellation of indebtedness results in a gain at all, the treatment of such gain should be on exactly the same footing. If a creditor gratuitously and with intent to benefit his debtor reduces or cancels his indebtedness, the gain may be a gift. If a creditor forgives a debt or accepts less than is owing on account of services rendered to him by the debtor or as a distribution to stockholders or in exchange for property transferred by the debtor, the debtor's gain may be income. But if the creditor accepts less than the face amount of the indebtedness in an arm's-length transaction divorced from other circumstances, any gain the debtor has is not derived from labor or capital and is not income.

Such are the facts in this case. The taxpayer being personally acquainted with the holders of his bonds, but having no other relationship with them, negotiated with them for the purchase of the bonds for less than their face

amount. The creditors, for reasons of their own, saw fit to accept the offered amount. Their decision was made in an arm's-length, self-contained transaction, not to compensate the taxpayer, for any services or otherwise. If the taxpayer had a gain from those transactions, it cannot be said that the gain was derived from his labor or capital. It was therefore not income.

If the taxpayer had purchased from these creditors the bonds of another, at less than their face value, certainly the Petitioner would not claim that he had income. Even if the Petitioner found that such a purchase was for less than the bonds were worth, so that the taxpayer had a gain in assets, Petitioner would not claim that the taxpayer had income. If he had purchased law books at less than their going market value, or had purchased a home at less than it was worth, there would be no income—provided such purchases were self-contained transactions not intended to compensate.

Certainly, the present transaction does not differ—and income does not here result—simply because the gain resulted from a decrease in liabilities with no increase in total assets, rather than from a simple increase in assets through a bargain purchase. It might be urged that where a taxpayer acquires property at a bargain price, tax on the gain is not eliminated but is rather postponed, but that is by no means uniformly true of bargain purchases. The property may never be sold, or it may be sold at a loss rather than a gain. If the property is consumed or if it is a personal property such as a residence, its ultimate disposition may have no effect on taxable income. Refusal of the courts to tax a mere bargain purchase, not derived from labor or capital, is not due to the possibility that in some such cases a similar tax may be later exacted. Indeed, the courts well know that they have no power, absent specific legislation, to postpone the tax on current income or in any guise defer it to another period. If a present gain is income, the courts have no power to

exempt it from tax simply because the same gain may be taxed later.

The obvious truth of the matter is that income is not determined from the existence of a gain alone. That is true whether the gain results from an appreciation in assets, from a bargain purchase, from the elimination of a burden on property or from the cancellation of indebtedness. The gain is income only where in the light of the whole transaction it comes to the taxpayer as a consequence of his labor or dealings in property.

A consistent application of these principles to problems of cancellation of indebtedness would go far toward reducing the confusion now existing in this field. The decision of this Court in the *American Dental Co.* case and the decisions of the lower courts in most of the cases which have followed it, would stand unaffected. Whether such a purchase by a taxpayer of his bonds at a discount as was involved in the *Kirby Lumber Co.* and *American Chicle Co.* cases would result in taxable income would depend upon a fuller review of the circumstances of the case than was provided in this Court's opinions. Instead of a maze of technical and frequently conflicting rules and exceptions, the simple touchstone would be the intent of the parties.

Cancellation of indebtedness would then cease to be an esoteric field remote from the understanding of men of business and an exception to the general principles of income taxation. Whether a debtor received taxable income on the reduction of indebtedness would not be dependent upon unrealistic distinctions but upon the common understanding of financial transactions. As has been said by Mr. Magill, commenting with approval on the holding in the *American Dental Co.* case:

"There are practical considerations in favor of the majority opinion: the essential unreality of holding that a taxpayer in difficult financial circumstances has realized income when his creditors, in order to keep him in business, forgive all or part of his indebtedness to them." (*Magill, Taxable Income*, p. 255).

Fortunately, the practical unreality of finding income as a result of such a debt forgiveness coincides exactly with the legal impossibility of finding income unless a gain is derived from labor or capital. As we believe we have demonstrated, proper legal analysis of the concept of income concurs in its findings with the practical realities. On both legal and practical grounds, the cancellation of indebtedness arrived at in an arm's-length transaction unaffected by other circumstances is not income.

### CONCLUSION.

The court below has properly held that within the existing framework of this Court's decisions reduction of the taxpayer's indebtedness through the purchase of his bonds at less than their face amount did not result in taxable income. Since it was a gratuitous cancellation of indebtedness resulting from personal dealings between the parties, we believe that that holding is correct and should be affirmed.

Likewise, if this Court determines to re-examine its previous decisions on this subject, we submit that proper application to gains from cancellation of indebtedness of principles long and well established in other fields of income taxation, requires the conclusion that a self-contained cancellation of indebtedness not intended as compensation, for services or otherwise, cannot be found to result in taxable income. Upon any such re-examination, therefore, the decision of the court below should be found to be correct and affirmed.

Respectfully submitted,

WM. B. COCKLEY,

SIDNEY C. NIERMAN,

THEODORE R. COLBORN,

WALTER A. MARTING,

*Attorneys for Lewis F. Jacobson,*

*Respondent-Taxpayer.*